

Minnesota

Department of Finance

Economic Update

October 1998

State Revenues At Forecast Level

First quarter general fund revenues, excluding tobacco settlement payments, totaled \$2.47 billion in fiscal 1999, \$22.9 million (0.9 percent), more than forecast. Even though the national and international economic outlook has grown more fragile since February, Minnesota revenues during the first 3 months of fiscal 1999 were very close to February's forecast. In September Minnesota also received a payment from the tobacco settlement. That added an additional \$240 million to the state general fund.

Revenue Summary: F.Y. 1999 Year to Date

	<u>Forecast</u>	<u>Actual</u>	<u>Variance</u>	<u>Percent</u>
	-----Dollars in Millions-----			
Individual	1,236.8	1,234.8	(1.9)	(0.2)
Sales	730.7	734.1	3.4	0.4
Corporate	199.2	179.0	(20.2)	(10.1)
Motor Vehicle	104.7	122.3	17.6	16.8
Other	<u>175.9</u>	<u>200.1</u>	<u>24.1</u>	13.8
TOTAL	2,447.3	2,470.2	22.9	0.9

Tobacco Settlement Payment		240.0		

Receipts from Minnesota's four major taxes were a combined \$1.2 million less than forecast. Variances for the individual income and sales taxes were very small and well within historical norms. The variance in motor vehicle excise tax receipts appears related to current auto industry discounting and promotions. The drop in corporate income tax receipts is consistent with widespread reports of lower corporate profits. A cut in the corporate income tax forecast is likely in November. Other tax and non-tax revenues were up \$24 million, (13.7 percent). Mortgage and deed tax revenues and investment income were the source of most of that additional revenue. (See page 4). General fund revenues for the first quarter of 1998, exclusive of the tobacco settlement, are up 6.0 percent (\$140 million) over collections during the first quarter of 1998.

The preliminary revenue variance for fiscal 1998 has been increased from that reported in July. Net general fund revenues for fiscal 1998 are now estimated at \$10.276 billion, \$333 million more than forecast, and \$17 million more than previously reported. A final report on fiscal 1998 revenues will be released as part of the next revenue forecast.

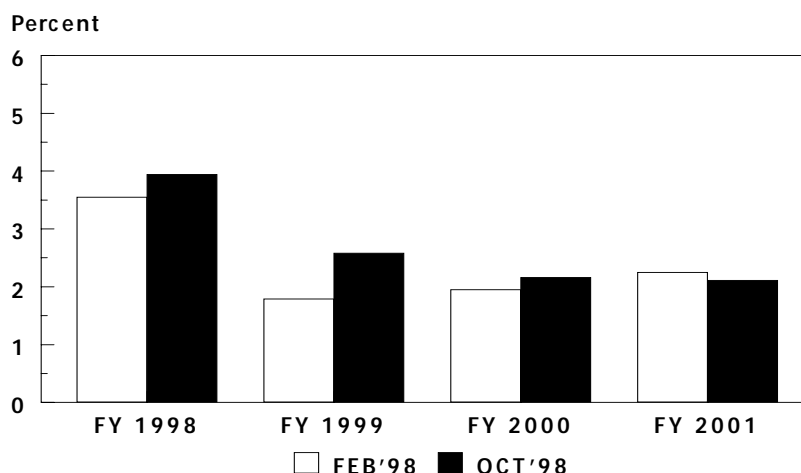
International Uncertainties Increase Risk to Forecast

Signs of weakness in the U.S. economy have emerged recently, but economists believe the Federal Reserve once again will be able to avoid a recession and turn the coming slowdown into a soft landing. U.S. unemployment rates remain well below 5 percent and there have been few signs that households might cut back on their spending. Since consumer spending is two thirds of the economy, a U.S. recession is unlikely unless growth in consumer spending slows.

There are, however, concerns on the international front. Last quarter the international economic situation deteriorated noticeably. Asia's economic weakness spread to Russia and to Latin America as demand for basic commodities, particularly oil, fell. In Russia the result has been devaluation of the ruble, re-establishment of foreign exchange controls, and the re-scheduling of government debt. Those actions had a disproportionate impact on global markets because the devaluation and debt re-scheduling further weakened balance sheets of major financial institution throughout the world.

Now the international community is focused on the financial health of Brazil, a more significant player in the global economy and an important U.S. trading partner. A Brazilian devaluation could easily lead to devaluations elsewhere in Latin America, putting further pressure on U.S. exports and on U.S. financial institutions holding Latin American credits. Such a series of devaluations could well cause another collapse of Asian currencies, further worsening the financial problems in that region. Were that to occur, few believe the U.S. economy could escape a recession.

Slower But Steady Real GDP Growth Forecast for F.Y. 2000-01



At this point Data Resources Inc., (DRI), Minnesota's national economic consultant continues to believe that a recession can be avoided in 1999. DRI expects real GDP growth at an annual rate of 2.6 percent during fiscal 1999, followed by growth at a 2.1 percent annual rate during both fiscal 2000 and 2001. DRI assigns their October Control scenario a probability of 55 percent. The probability attached to a 1999 recession has been raised by 10 percent since July, and now is at 30 percent. A separate scenario containing a recession in 2000 is assigned a probability of 15 percent. DRI cautions that "The odds of a recession are nearly 50 percent within the next two years."

Stock Market Adds Uncertainty to Revenue Forecast

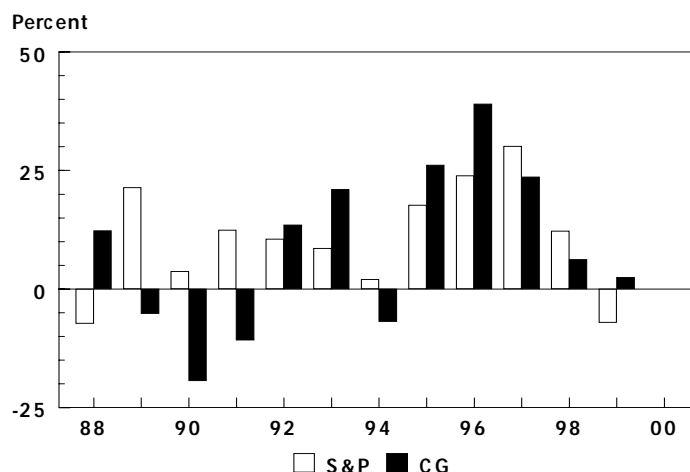
Estimating the impact of the stock market on tax revenues has become an increasingly important part of federal and state revenue forecasts. There is econometric evidence that consumer spending is affected by stock market growth, and large increases or decreases in the stock market are also likely to affect consumer decisions on whether to spend or save. A significant extension of the current correction or a quick move back to July's highs would likely cause most forecasters to revise their outlook for future U.S. economic growth.

Recently, much of the unexpected growth in federal and state revenues has come from higher than anticipated capital gains income, and sales of corporate equities are the largest portion of capital gains for most taxpayers. While capital gains income was just eight percent of federal taxable income in 1996, its volatility makes that income source difficult to forecast.

Minnesota residents reported capital gains income of about \$4 billion for tax year 1996, a gain of more than 47 percent over 1995 levels even after excluding stockholder gains from one particularly large merger. Nationally, capital gains realizations are now estimated to have grown by 40 percent in 1996. Although data on 1997 incomes will not be available until January, 1999, capital gains realizations appear to have grown by more than 20 percent rate forecast in 1997.

Minnesota's current revenue forecast anticipates that capital gains income will grow again in tax year 1998. History shows though that capital gains income can drop, and there is no strong relationship between capital gains realizations and changes in the stock market. In some years capital gains revenues have fallen when the stock market rose. This year, with the stock market's dramatic growth in the first half of the year followed by its recent slump, revenues will depend on whether investors realized their gains by selling stocks earlier in the year, or whether they have continued to hold their profitable investments.

Capital Gains and the Stock Market
(Annual Growth Rates - History and Forecast)



Comparison of Actual and Estimated Non-Restricted Revenues (\$ in thousands)

	<u>1998 Fiscal Year</u>			<u>July - Sept. 1998</u>		
	<u>Forecast</u> <u>Revenues</u>	<u>Actual</u> <u>Revenues</u>	<u>Variance</u> <u>Act-Fcst</u>	<u>Forecast</u> <u>Revenues</u>	<u>Actual</u> <u>Revenues</u>	<u>Variance</u> <u>Act-Fcst</u>
Four Major Revenues:						
Individual Income Tax						
Withholding	4,166,327	4,172,413	6,087	1,044,100	1,031,164	(12,936)
Declarations	903,712	934,108	30,395	185,900	193,947	8,047
Miscellaneous	522,861	499,666	(23,195)	39,798	38,909	(889)
Gross	5,592,900	5,606,187	13,287	1,269,798	1,264,020	(5,778)
Refunds	1,061,500	856,654	(204,846)	33,032	29,187	(3,845)
Net	4,531,400	4,749,533	218,133	1,236,766	1,234,833	(1,933)
Corporate & Bank Excise						
Declarations	780,112	743,025	(37,087)	188,500	177,897	(10,603)
Miscellaneous	90,520	101,616	11,096	20,486	18,133	(2,352)
Gross	870,632	844,642	(25,990)	208,986	196,030	(12,956)
Refunds	89,632	92,581	2,949	9,800	17,060	7,260
Net	781,000	752,061	(28,939)	199,186	178,970	(20,216)
Sales Tax						
Gross	3,348,900	3,385,656	36,756	763,690	779,515	15,825
Refunds	133,000	127,221	(5,779)	33,000	45,432	12,432
Net	3,215,900	3,258,435	42,535	730,690	734,083	3,393
Motor Vehicle Excise	417,800	444,976	27,176	104,700	122,280	17,580
Other Revenues:						
Inherit/Gift/Estate	40,812	62,366	21,554	12,293	13,988	1,695
Liquor/Wine/Beer	56,407	57,455	1,048	11,306	11,954	648
Cigarette & Tobacco	174,868	175,854	986	36,482	36,766	284
Deed and Mortgage	105,900	120,212	14,312	30,548	40,595	10,047
Insurance Gross Earnings	155,000	163,187	8,187	1,600	2,598	998
Lawful Gambling	63,231	64,918	1,687	13,344	14,234	890
Health Care Surcharge	119,868	122,367	2,499	26,730	28,394	1,664
Other Taxes	3,480	3,727	247	210	298	88
General Fund RTC Revenues	34,503	35,451	948	5,920	5,935	15
Income Tax Reciprocity	37,872	37,872	0	0	0	0
Investment Income	146,000	163,338	17,338	22,409	28,647	6,238
Other and Unallocated	80,000	94,584	14,287	18,159	18,367	108
Other Subtotal	1,017,940	1,101,034	83,093	179,001	201,777	22,775
Other Refunds	21,338	30,032	8,694	3,069	1,727	(1,342)
Other Net	996,602	1,071,299	74,399	175,940	200,050	24,118
Total Gross	11,248,172	11,382,792	134,620	2,526,183	2,563,621	37,446
Total Refunds	1,305,470	1,106,488	(198,982)	78,901	93,406	14,505
Total Net	9,942,702	10,276,006	333,303	2,447,282	2,470,215	22,941